the only way a firm could increase sales would be through lower prices. The SBC executive who constructed this estimate, however, appears to have assumed that prices would remain unchanged.[41] How could the merged firm increase sales without lowering prices?

The answer to this question lies in the realization that, contrary to the assumption of the textbook model, not all firms in real markets are employing best practices all the time. Instead, best practices take time to diffuse across an industry. Mergers can hasten this diffusion, as best practices can be transferred within an organization at a lower communication cost and without the fear that strategically important knowledge will be misused by outsiders.[42]

Martin Kaplan's affidavit describes the gain in sales largely as a result of the spread of best practices in marketing and sales.[43] In economic terms, these practices can best be understood as a way of increasing demand (shifting the demand curve to the right) by making more customers aware of services that they would like to buy if they knew about them. There is no reason that a firm with market power – or even a monopolist – would not find this diffusion of best practices and resulting expansion of sales in its best interest. Therefore, the entire $778 million should be counted as a benefit that will accrue to consumers even if the merged firm possesses substantial market power.

In short, even in the worst case, the merged firms have incentives to flow a substantial portion of the benefits through to consumers.

The proposal to offer out-of-region residential service is credible.

[41] Kaplan Affidavit, para. 7.
[42] For a fuller explanation, see above, pp. 8-10.
[43] *Id.*

The Applicants claim that their business plan would put them in competition for residential as well as business customers in 30 large markets outside their own territory. If this competition actually occurs, it could confer substantial benefits on residential customers.

As a rule, CSE Foundation is skeptical of this type of claim, largely because of the history of telecommunications regulation. For much of this century, regulation has sought to keep local residential rates below actual cost by charging businesses artificially high prices.[44] Such policies encourage the average consumer to think he is a beneficiary of regulation, because the lower residential rates are highly visible, but the higher costs of telephone service for businesses are hidden in the prices the customer pays for all other goods and services.[45] In our view, this is nothing but a shell game that actually makes consumers, on the whole, worse off by reducing the productive capacity of the American economy.[46] Nevertheless, since this is how the game is played, it would not surprise us at all if SBC and Ameritech propose to offer local residential service simply as a regulatory *quid pro quo* to get approval of the merger and an opportunity to win (or retain) more business from their large corporate customers. If residential service turns out to be unprofitable, we would not expect a significant effort to be sustained over time.

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[44] See Wayne Leighton, "Telecommunications Subsidies: Reach Out and Fund Someone – Whether You Want to or Not," CSE Foundation *Issues and Answers* (Jan. 5, 1995). See also Crandall and Waverman, *Talk is Cheap*, at 76-95.

[45] Economic scholarship demonstrates that policymakers and regulators have an incentive to adopt policies and regulation that combine visible benefits with hidden costs. See Richard Posner, "Taxation by Regulation," *Bell Journal of Economics and Management Science* 2:1 (Spring 1971), pp. 22-50; Michael Crew and Charles Rowley, "Toward a Public Choice Theory of Monopoly Regulation," *Public Choice* 57 (1988), pp. 49-67.

[46] If public policy inflates the prices charged to highly price-sensitive customers, such as businesses, they will cut back their use of telecommunications a great deal. Lower local rates for customers who are not very price-sensitive, such as residential users, will transfer wealth to them but will not induce them to use much more telecommunications services. Therefore, the output of the telecommunications industry is inefficiently low. See Robert Crandall, *After the Breakup*, at 135-45; Wayne Leighton, *Telecommunications Subsidies: Reach Out and Fund Someone*.

In this case, though, the Applicants' proposal to offer residential service in the new markets they enter is credible because it reflects fundamental economic realities. Once their switches and fiber network are in place in the new cities, they have a natural incentive to hook up residential subscribers in order to maximize throughput. In addition, unlike some of the competitive local exchange carriers, SBC and Ameritech already have substantial experience marketing and providing service to residential subscribers.

In addition, the distinction between residential and business markets is itself blurring because of the growth in telecommuting. When telecommunications provide the crucial link to let people use their homes extensively for business, the regulatory distinction between "business" and "residential" customers makes less sense. Telecommuting is a significant and growing phenomenon,[47] especially for the types of large companies that SBC and Ameritech propose to follow out of their home regions:

- The most recent survey by FIND/SVP shows that approximately 11 million Americans telecommuted in 1997, up from 8.5 million in 1995 and 9.7 million in 1996. Telecommuting has grown at an average annual rate of 15 percent over the past two years.[48]
- In a May 1997 survey, Watson Wyatt Worldwide found that 51 percent of America's largest employers offer telecommuting.[49]

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[47] The Center for the New West provided an early study of where knowledge workers make there homes in a 1991 study, "The Great Plains in Transition: Overview of Change in America's New Economy." Center president Philip M. Burgess has named these workers Lone Eagles. In a *Rocky Mountain News* column (May 23, 1994) he wrote, "Lone Eagles are the first wave of those who are changing the way we live, work, play, learn and move around because of the telecommunications revolution. [They] may represent America's most important lifestyle change since the rise of the two-wage-earner family of the 1970s."
[48] "US Telecommuting Trend Surpasses 11 Million," at http://etrg.findsvp.com/prls/pr97/telecomm.html.
[49] See www.langhoff.com/advice.html#stats.

- Approximately 30 million Americans do some part of their work at home; this figure includes telecommuters, people who bring work home in the evening, and home-based businesses.[50]
- Jack Nilles, the former professor and consultant who invented the term "telecommuting," projects that 24.7 million employees – 18 percent of the workforce – will telecommute by the year 2000, and 30 million will do so by the year 2005. Nilles has a strong record; actual survey results have tracked his forecasts for a number of years.[51]

Telecommuting is an especially important phenomenon, because a phone company serving a business with telecommuters already has access to a pool of employees who are natural candidates to subscribe to its residential service. Both the corporate client and its employees have a strong interest in ensuring that telecommunications services in the home provide seamless connections to the business location. A phone company serving both locations is in a strong position to guarantee seamless connectivity. In addition, due to the pre-existing relationship with the employer, marketing costs for this group of residential customers will likely be lower. The phone company can thus leverage[52] its business relationship with the company into an opportunity to serve employees.

The merger creates incentives for voluntary unbundling by SBC and Ameritech.

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[50] Toffler and Toffler, *Creating a New Civilization*, at 87.
[51] See http://www.jala.com.
[52] We mean "leverage" here in the business strategist's sense, not in the monopolistic sense.

Even after passage of the 1996 Telecommunications Act, the issue of unbundling elements of local telephone service has remained contentious. Long-distance and competitive local exchange carriers sometimes claim that the local phone companies are dragging their feet on unbundling. Local phone companies claim that they are complying with the Act as rapidly as possible, and they claim that long-distance companies have refrained from entering the local service market in order to prevent local companies from receiving permission to enter the long-distance market.

The SBC-Ameritech merger and accompanying business strategy give SBC and Ameritech superior incentives to unbundle as rapidly as possible. The principal reason is that success of the national-local strategy depends critically on their ability to obtain unbundled local service from carriers outside of their current service territories. "SBC and Ameritech themselves plan to rely heavily on unbundled elements in implementing the National-Local Strategy."[53] It is true that the merged companies plan to place their own switches and fiber optic cable in the 30 largest markets outside their territories. However, in order to reach residential customers in those cities, they will still need to access the incumbent local carrier's lines. SBC and Ameritech will likely be frustrated in this goal if they themselves engage in behavior that frustrates other carriers who want access to unbundled elements of their facilities in their own service territories.

The two companies plan capital expenditures of more than $2 billion and operating expenses of $23.5 billion over 10 years to enter other local markets.[54] These expenditures will lose most of their value if the national-local strategy fails. In essence, SBC and Ameritech are pledging billions of dollars as a hostage that they would lose if

[53] SBC-Ameritech Application, at 79.
[54] Kahan Affidavit, paras. 57-58.

they engaged in foot-dragging on unbundling that would cause the national-local strategy to fail.

The merger creates a "maverick firm" in regard to unbundling.

The Commission has previously noted that a merger can create consumer benefits "by enhancing the incentive of a maverick firm to lower price or by creating a new maverick firm."[55] The proposed merger, in combination with the proposed expansion into new territories, creates a new maverick firm that has incentives different from those of a typical local exchange carrier.

If all incumbent local exchange carriers largely confine their operations to their own regions and to lines of business that do not require purchase of unbundled network elements from other local exchange carriers, then all might have an incentive to resist unbundling in order to preserve barriers to entry. In contrast, the firm formed by the SBC-Ameritech merger will have significant operations in 30 markets outside its local service territory. The success of those operations depends critically on effective unbundling by the local exchange carriers in those markets. The national-local strategy thus gives the merged firm an interest in other firms' unbundling efforts similar to that of the interexchange carriers and competitive local carriers. In the battle over unbundling, the interexchange and competitive local carriers would acquire an ally with considerable knowledge of local exchange operations. The appearance of this ally can only hasten the process of unbundling in markets outside of the current SBC-Ameritech service territory.

Even if the consumer benefits are unsure, the merger should be allowed to proceed.

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[55] *In the Applications of NYNEX and Bell Atlantic*, para. 169.

The Commission's decision on this merger need not hinge on the size and likelihood of the consumer benefits. As the Commission noted in its decision on the SBC-Pacific Telesis merger, "A demonstration that benefits will arise from the merger is not, however, a prerequisite to our approval, provided that no foreseeable adverse consequences will result from the transfer."[56] We believe that this merger poses no more of a threat to competition than the SBC-Pacific Telesis merger. Therefore, even if some of the prospective consumer benefits are speculative and uncertain, the merger should be allowed to proceed.

IV. CONCLUSION

All mergers are by nature speculative. Some succeed, and others eventually turn out to have been based on mistaken judgment or perceptions. Nevertheless, the proposed merger of SBC and Ameritech appears to be based on a plausible understanding of the way telecommunications markets are changing.

Regardless of whether the merger ultimately succeeds or fails as a business proposition, the Commission should approve it. There is no risk that the merger will harm consumers through monopolistic exploitation, and there is credible evidence that it will produce benefits for consumers.

Respectfully submitted,

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[56] *In Re Pacific Telesis and SBC Communications* (Jan. 31, 1997), para. 2.